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EXAMINATION OF THE IMPACT OF BOOK ENTRIES ON CREATIVE ACCOUNTING

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ABSTRACT

Creative Accounting is the transformation of financial accounting figures from what they actually are to what the management desire by taking advantage of the existing rules and/or ignoring some or all of them (Naser, 1993). However the question remains: at what point does creative accounting creep into the financial statements to cause the desired havoc? In other words; DO management use book entries as strategic tools for income smoothing which results in material misstatements in the financial statements? Given that Creative Accounting is the transformation of financial accounting figures from what they actually are to what the management desire, it is debatable whether creative accounting starts from book entries, even source documents. After all where then lies the element of transformation? This paper examines the impact of book entries on creative accounting and shows how management uses book entries for creative accounting practices in Nigeria. It adopts a survey research method polling a sample size of 200 (Taro Yameni formula) from a population of 600 senior audit staff of the big four audit firms in Nigeria and uses the Statistical Package for Social Sciences (SPSS 16 package, 2007) to test the hypothesis that: Book Entries are not used for creative accounting practices but creative accounting practices have significant effect on audit risk. This hypothesis was accepted at 5% level of significance. It was recommended among other things that auditors should apply themselves and focus critically on source documents and various external audit evidence in order to discover creative accounting practices.

KEYWORDS: Book Entries, Creative Accounting, Audit Risk and Audit Failure, Deferred Tax and Depreciation

INTRODUCTION

The topic of this study is the examination of the impact of Book Entries on Creative accounting. Creative accounting is the transformation of financial accounting figures from what they actually are to what the management desire by taking advantage of the existing rules and/or ignoring some or all of them (Naser1993). Then Book Entries according to Mulford and Comiskey (2002) refers to the double entries that are used to create inter alia future events. When fictitious revenue is recognized, a book entry is used because no real transaction exists, for example aggressive capitalization and extended amortization policies as well as the revaluation of assets and liabilities, are brought about by Book Entries. In like manner, when items in the income statement as well as the cash flow statement are reclassified, book entries are also used. Management uses book entries as strategic tools and in the long run, this may harm outside stakeholders and may result in

material misstatements in the financial statements. Thus when financial statements are materially misstated with the use of book entries without being detected by the external auditor, they may give an inappropriate opinion.

In the United States, failure of corporations such as Enron Corp, WorldCom Inc., and Waste Management Inc, was also traced to the practice of Creative Accounting through the use of book entries which often go unnoticed by the auditors during their audit work. Thus, it would appear that a 'properly' done audit does not guarantee that serious distortions of the financial statement often described as creative accounting practices had not occurred. However creative accounting involves both income statement and balance sheet manipulations. The audit opinions of external auditors are fundamentally based on the outcome of their examination of both the income statement and the balance sheet. Copeland, (1968) views Creative accounting as involving the repetitive selection of accounting measurement or reporting rules in a particular pattern, which in effect report a stream of income with a smaller variation from trend than would otherwise have appeared. Barnea et al (1976) on the other hand view Creative Accounting as the deliberate dampening or fluctuation in some level of earnings considered to be normal for the firm. Though the advocates of this approach argue that it is a measure against the short- termism of judging an investment on the basis of the yields achieved in the immediate following years It also avoids raising expectations so high in good years that the company is unable to deliver what is required of subsequently. Again it is argued that if the trading conditions of a business are in fact volatile then inventors have a right to know this and that income smoothing may conceal long-term changes in the profit trend.

The professional accountant sees Creative Accounting generally as ethically dubious. In the USA, the then senior partner of Price Waterhouse observed: When fraudulent reporting occurs, it frequently perpetrated at levels of management above those for which internal control system are designed to be effective. It often involves using the financial statements to create an illusion that the entity is healthier and more prosperous than it actually is. This illusion is sometimes accomplished by masking economic realities through intentional misapplication of accounting principles.(Conner 1986)In Australia Leung and Cooper (1995) found that in a survey of one thousand five hundred (1500) accountants, the three ethical problems cited most frequently were conflict of interest, client proposal to manipulate accounts and client proposal for tax evasion, also two surveys of attitudes to creative accounting in USA both highlight a difference in accountants' attitudes to creative accounting depending on whether it arises from abuse of accounting rules or from the manipulation of transactions.

In view of the foregoing, we ask the fundamental question; to what extent does companies in Nigeria use Book Entries as creative accounting techniques? We therefore state the tentative conjectural statement that there is a significant difference between the adjusted and the unadjusted ratios due to the use of Book Entries as creative accounting techniques in manipulating the information content of annual financial statements of companies in Nigeria'. By debunking the general believe that management's creative accounting techniques centre around deferred tax and depreciation, we argue that management go far beyond deferred tax and depreciation to create complete and separate sets of accounting records as creative accounting techniques to manipulate accounting records to suit their selfish purpose.

REVIEW OF RELATED LITERATURE

According to Agency Theory, the firm is a legal fiction which serve as focus for complex process in which the conflicting objectives of individuals are brought into equilibrium within a frame work of contractual relations (Jenson and Meckling, 1976) A common form of agency relationship is that found between managers and shareholders in a firm. Managers are agents of shareholders who, as principals seek returns on their investment (Quinn and Jones, 1995). The normative implication is that managers maximize the net present value of the firm, which is supposed to be the

shareholders gaol (Shankman, 1999). The conflicting objectives of the groups within and outside the firm usually results in self serving activities that are aimed at making one group better off without an intention to make the firm worse off. The managers are interested in paying lower taxes and dividends, the shareholders in gaining higher dividend, the employees to obtain better salary and higher profit share and the government to collect more taxes. The conflict of interest often provides an incentives for creative accounting behavior; that is the tendency to manipulate accounting figures of the firm in order to meet the self serving objectives of the different stakeholders of the firm. Corporate firms operate not as separate legal entities, but rather constitute a 'nexus of contracts' between individuals (Jensen and Meckling, 1976). Therefore, within the agency framework, it is both logical and inescapable that management behavior will be self serving. Agency can, therefore provide a solid framework for understanding of creative accounting behavior. Thus, agency theory provides the logic and a solid framework to understand self-serving management behavior. However, it may provide an incomplete theoretical basis for explaining or predicting management behavior. As observed by Horrigan,(1987) the ethical dimension of human behavior may provide an important element missing from legalistic and adversarial agency relationships. In agent/ principal relationship, behavioral accountability is deeply rooted in what Iwu-Egwuonwu (2010) refer to as behavioral and ethical governance. It is a form of accountability. It is a form of accountability that should precede financial accountability because without it, no accountability is meaningful. However creative accounting involves both income statement and balance sheet manipulations. The examination of both the income statement and the balance sheet forms the basis upon which the external auditors provide audit opinion. This accounting manipulations which involve both income statement and balance sheet would be the focus of this research.

Merchant and Rockness (1994) similarly found that, when presented with scenarios of creative accounting, accountants were more critical of abuse of accounting rules than of manipulation of accounting transactions. Fischer and Rosenzweig (1995) gave two explanations for accountants' attitudes thus, accountants may take a rule-based approach to ethics, rather on the impact of users of the accounts. Secondly they may see abuse of accounting rules as falling within their domain, therefore demanding their ethical judgment, while the manipulation of transactions falls within domain of management and so is not subject to the same ethical code. Another author Merchant and Rockness also found a difference in accountants' attitudes to creative accounting depending on the motivation of management. Creative accounting based on explicit motives of self-interest attracted more disapproval than where the motivation were to promote the company. An accountant, or other manager, who takes a stand against creative accounting faces the same pressures as any other whistleblower. In extreme cases failure to act could ruin a reputation. As one company accountant who took a firm stand states in Baldo (1995) "It cost me my job, but I don't think I would have gotten another job had I been unethical. Various research studies have examined the issue of management motivation towards creative accounting. Niskanen and Keloharju (2000) mentioned Tax as a significant motivator and also Herrmann and Inoue (1996) in a finished context in Japan .Other motivations for creative accounting as discussed by Healy and Wahlen (1999) include those provided when significant capital market transactions are anticipated, and when there is a gap between the actual performance of the firm and analysts' expectations. A variant on income smoothing is to manipulate profit to tie in to forecasts.

In countries with highly conservative accounting systems the 'income smoothing effect can be particularly pronounced because of the high level of provisions that accumulate. A report on how accounting policies in some companies are designed within the normal accounting rules, to match reported earnings to profit forecast. When these companies sell products a large part of the profit is deferred to future years to cover potential upgrade and customer support costs. This perfectly respectable and highly conservative accounting policy means that future earnings are easy to predict. Company directors may keep an income-boosting accounting policy change in hand to distract attention from

unwelcome news. From management point of view, Healy (1985) examines managers' earnings manipulations motives where executive compensation is linked to income measurement. On the other hand, Truemen and Titman (1988) discuss managers' motivations to reduce the perception of variability in underlying economic earnings of the firm. In the case of Cadbury Nigeria plc, the managing director and the finance director were sacked on account of manipulating the company's financial books. According to the company's Public Affairs Manage, "Over the number of years, Cadbury Nigeria (management) had assigned itself an ambitious growth target" (Okoye and Alao, 2008) Diana and Madalina (2008) identified the objectives of three major stakeholders in the firm as the main motivations for account manipulation. They identified managers of the firm, the fund providers and the society as major stakeholders in the firm. The managers seeking to maximize their compensations, minimize the firm's cost of capital and the cost of taxations and its contribution to the society; engage in account manipulation to achieve these objectives

Accounting concentrates on the events, transactions and occurrences that can be described as resources as resource flows. Flows necessarily involve a certain dualism, in other words a source and a destination. Therefore record keeping is "depicting a conceived, rather than a fully perceived, flows of resources" (Goldberg 2001). Two possible dimensions are clearly distinguished here, "conceived", which refers to a creation of the mind and "perceived", which relates to observing reality. Accounting is the result of the procedures that have been installed to record invents, occurrences and transactions that have taken place and decisions that have been taken. They involve change in location, time and condition and may also be anticipated or predicted, but they only become actual occurrences when they do happen. In this case, there is no question of reality. The future happenings are made up, a product of the mind. The balance sheet therefore involves a backward as well as a forward.

In a more recent study, Solowy (2000) see creative accounting as 'an assembly of procedures in order to change the profit, by increasing or to misrepresent the financial statements, or both of them'. Companies generally prefer to report a steady trend of growth in profit rather than to show volatile profits with a series of dramatic rises and falls. This is achieved by making unnecessarily high provision for liabilities as against assets values in good years so that these provisions can be reduced, thereby improving reported profits, in bad years (Amat and Gorthworpe 1999). Advocates of this approach that it is a measure against the 'short- termism' of judging an investment on basis of the yields achieved in the immediate following years. It also avoids raising expectations so high in good years that the company is unable to deliver what is required subsequently. Against this is argued that if the trading conditions of a business are in fact volatile then investors have a right to know this and that income smoothing may conceal long term changes in the profit trend. The literature on the ethics of bias in accounting policy choice is reviewed at the 'macro' level of the accounting regulator. This literature can similarly be applied to the bias in accounting policy choice at the 'macro' level of the management of individual companies that is implicit in creative accounting. Ruland (19n84) distinguishes between the deontological view where by moral rules apply actual actions and the teleological view that an action should be judged on the bases of the moral worth of the outcome. Unlike Ruland's study, Revisine appears to take a teleological view of accounting in the private sector, allowing managers to choose between the alternatives permitted in 'loose' standards to achieve there desired end, but to take a deontological view of accounting in the public sector where he calls for tighter standards to prevent such manipulation. One might ask whether the presence or absence of market discipline justifies such ethical inconsistency. Ruland also discusses the distinction between a 'positive' responsibility; that it should be the duty to present unbiased accounts and a 'negative' responsibility were managers would be responsible for states of affairs they fail to prevent. Thus it is explicit that Ruland gives priority to the 'positive' responsibility concept. Within Revisine's framework, where all outcomes are deemed to be impounded in the process of contracting and price-setting, the distinction is not

acknowledged. To Ruland 'duty to refrain' would imply avoiding the bias inherent in creative accounting while the 'duty to act' would involve pursuing the consequences to be achieved by creative accounting. Ruland sees the 'duty to refrain' the more important. Revisine seems to see compliance with Generally Accepted Accounting Practice (GAAP) as the prime responsibility of the management, with no constrains on choice within GAAP. This may be a legitimate approach in countries where there is flexibility in a jurisdiction that prescribes an overriding qualitative objective for accounts with true and fair view. To the professional accountant creative accounting generally seems to be regarded as ethically dubious. In USA, the then senior partner of Price Waterhouse observed: When fraudulent reporting occurs, it is frequently perpetrated at levels of management above those for which internal control systems are designed to be effective. It often involves using the financial statements to create an illusion that the entity is healthier and more prosperous than it actually is. This illusion sometimes is accomplished by masking economic realities through intentional misapplication of accounting principles (Conner, 1986). Moizer, (1997) identified two types of ethical reasoning; Consequentialism and Deontology. In Consequentialism, actions are judged based on the consequences that it results, whereas in deontology some acts are morally obligatory in spite of their consequences. According to Lei (2009) the ethical position that an auditor has will influence his/her decision in terms of auditor independence and honest reporting. Thus an auditor could adopt the deontological stance because it is wrong to be dishonest. This type of person therefore would not give an audit opinion that he/she knows to be wrong due to creative accounting practices, even though the consequences of issuing an honest opinion are expected to be terrible for a number of other stakeholders of the firm. In view of the above arguments, this study seeks to examine the effect of the ethical perception of creative accounting by the auditors who have the responsibility of giving an independent opinion on the financial statements audited by them. Fox (1997) reports on how accounting policies in some companies are designed within the normal accounting rules, to match reported earnings to profit forecasts. When these companies sell products a large part of the profit is differed to future years to cover potential upgrade and customer support costs. This perfectly respectable and highly conservative accounting policy means that future earnings are easy to predict. Company directors may keep an income-boosting accounting policy change in hand to distract attention from unwelcome news.

METHODOLOGY

The research was conducted in Nigeria and it adopted an ex-post factor design. Secondary data was collected from the Annual Reports of the sampled companies. Two different ratios were computed; one in the traditional way and the other by adjusting the deferred tax and depreciation which are the major book entries allegedly used as creative accounting techniques. An independent samples t-test was used to statistically obtain the significant difference between the unadjusted and adjusted ratios. Then the significance of the t value is compared against the statistically accepted bench mark of 0.05. If the significant value is greater than 0.05, the null hypothesis stands rejected and the alternative hypothesis accepted. The t-test statistic was used to test the hypothesis through the Micro Soft Special Package for Social Sciences (SPSS) version 16.0

FINDINGS AND DISCUSSIONS

We test the null hypothesis that 'there is no significant difference between the unadjusted and adjusted ratios due to the use of Book Entries as creative accounting techniques in manipulating the information content of annual financial statements of companies in Nigeria'. If this hypothesis is not rejected, then we reject the alternative hypothesis ' that there is a significant difference between the adjusted and the unadjusted ratios due to the use of Book Entries as creative accounting techniques in manipulating the information content of annual financial statements of companies in Nigeria'.

Table 1: An Independent Sample T- Test

Ratio	Mean	SD	T Value	Sig.
Unadjusted Adjusted	0.41 0.39	0.39 0.38	0.137	0.891

RESULTS

An independent samples t-test was used to statistically obtain the significant difference between the unadjusted and adjusted ratios. Then the value obtained (0.891) of the t-statistics is greater than 0.05 level of significance, thus there is no significant difference between the unadjusted and adjusted ratios. Therefore book entries are not used as creative accounting techniques.

Decision Rule

Since the t value is 0.137 < 2.000 and the significant value 0.891 > 0.05 at 5% level of significance we reject the alternative hypothesis and accept the null hypothesis. We conclude that Book entries are not significantly used as creative accounting techniques in Nigeria. The implication is that management does not fundamentally rely on Book Entries as are typified by deferred tax and depreciation in evolving creative accounting techniques. Therefore to manipulate the information content of the Annual Reports, the management goes far beyond the traditional Book Entries. They perfect strategies that enable them keep separate accounting records for the major items that appear in the financial statements. It is thus a thorough and impeccable fundamental fraud intended to satisfy the whims and caprices of top management at the expense of the other stakeholders and users of accounting information. That is, different sets of accounting records to wit, source documents, journals ledgers and other summary statements such as the trial balance are sufficiently provided to achieve whatever purpose management wants irrespective of the actual transactions of the entity. This automatically shows that Auditors should therefore intensify not only their vouching processes but also the evidencing procedures while doing the audit work.

CONCLUSIONS

Creative accounting is more deep rooted than the use of mere Book Entries as typified by deferred tax and depreciation techniques. Management perfect more fundamental bookkeeping fraud by keeping separate accounting records and not waiting for simple adjustments with respect to tax deferral and depreciation methods as creative accounting techniques. Critically our finding is that management does not significantly use Book Entries in form of deferred tax and depreciation in 'cooking' their books. . By debunking the general believe that management's creative accounting techniques centre around deferred tax and depreciation, we argue that management go far beyond deferred tax and depreciation to create complete and separate sets of accounting records as creative accounting techniques to manipulate accounting records to suit their selfish purpose. Hence, to achieve their selfish purpose, management keep different sets of accounting records for different purposes and use same to 'satisfy' the different users of accounting information content of the Annual Reports at the detriment of the survival and growth of the entity. In so doing the external auditors are hoodwinked and deceived into producing wrong audit opinions. It is recommended that in order to reduce audit risk and audit failure arising from creative accounting practices, auditors should dig deeper, do extensive evidencing and vouching and most importantly exhibit due diligence and high professional skill and ethics in a conducive environment of objectivity and independence.

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